

This record is a partial extract of the original cable. The full text of the original cable is not available.

C O N F I D E N T I A L SECTION 01 OF 03 BAGHDAD 003805

SIPDIS

E.O. 12958: DECL: 09/14/2015

TAGS: [EFIN](#) [ECON](#) [ELAB](#) [PGOV](#) [PINR](#) [IZ](#) [ECON](#) [IMF](#)

SUBJECT: SCENE-SETTER: FINANCE MINISTER'S CHALLENGES TO
BUDGET REFORM

REF: BAGHDAD 3453 (NOTAL)

Classified By: CHARGE D'AFFAIRES DAVID M. SATTERFIELD FOR REASONS 1.4 (b) AND (d).

1. (C) SUMMARY: After his fellow ministers rebuffed the 2005 budget supplemental, Finance Minister Allawi is trying to commit the next government to a 2006 budget that will pass muster with both the IMF and the Transitional National Assembly (TNA). This task will not be easy, but much is at stake including over 120 billion dollars in debt forgiveness. At the heart of Allawi's strategy is a decision to "starve" subsidies while working for better and cheaper alternatives, such as an oil trust fund that would pay cash to Iraqis. Once such an alternative is available, Allawi would eliminate food and fuel subsidies altogether. Beyond subsidies reform, Allawi's "top-down" approach to budgeting aims to make room for substantial increases in funding for security and for revenue-generating investment, particularly in the oil sector. He seems confident that the TNA will pass this sort of budget for 2006. Given its preoccupation with the upcoming constitutional referendum and elections, however, the TNA is unlikely to support bolder economic reforms (e.g., large fuel price increases) that would carry negative political repercussions. END SUMMARY.

2. (C) Minister of Finance Allawi faces multiple challenges as he struggles to provide funding for critical government operations this fiscal year. As reported refetel, the Council of Ministers failed to pass the supplemental because Allawi had sought to use a 2005 budget request as a vehicle to commit this government to reforming fuel price subsidies. In the face of the Council of Ministers rejection and the Prime Minister's reluctance to tackle fuel prices (which remain at 5 cents/gallon for gas and 3 cents/gallon for diesel), Allawi moved to use the 2006 budget process to commit this government -- and the next government -- to reforming both fuel prices and the public distribution system (PDS). His game plan is to have this government commit to a 2006 budget that will permit the GOI to sign an IMF SBA by year's end. Allawi expressed concern that the next government might be even less likely to undertake needed economic reforms unless palatable alternatives can be found. To develop such alternatives, he wants assistance to explore establishing a national oil trust and/or a new needs-tested welfare system that would replace the current food and fuel subsidies programs.

Economic Challenges

3. (C) The GOI economic team faces difficult challenges:

-- Insurgent attacks on power lines, oil pipelines, and refinery pipelines remain constant and negatively affect the Iraqi economy. Earlier 2005 GDP growth projections of 15 percent have been revised downward to about 4 percent.

-- Daily Iraqi oil exports that had been consistently above 1.5 million barrels per day (MB/d) from August 2004-March 2005 have drifted consistently below 1.5 MB/d in March 2005-August 2005. While increased oil prices have compensated in terms of revenue for lower overall exports, limited refining capacity means that Iraq has to import gasoline at world market prices -- only to sell most of it domestically at a loss, given a pump price of about 5 cents (US) per gallon. This has created a paradoxical situation in Iraq of a major oil-exporting country with long gas lines and fuel shortages.

-- Unemployment (active job-seekers and long-term unemployed) continues to climb, from 22.5 percent at the beginning of the year, according to some estimates, to an estimated 28 percent in August. 2005 inflation is currently running at about 33 percent annually.

-- This summer the average hours of electric power is 12 hours/day nationally, and about 7 hours/day in Baghdad. Repeated polling data has highlighted that these electric cuts remain a major source of anger and discontent toward the government. Naturally, power cuts also have a wide economic impact on the country.

14. (C) Any government would find managing an economy under such circumstances a daunting task. Complicating the GOI response is that, while there are a number of capable ministers in the Cabinet (Finance and Planning come to mind), at the critical Director General level and immediately below, many ministries are filled with staffs who are content to fall back on the familiar laws and regulations of the Saddam era. (COMMENT: In other ministries (Transportation is an example), ministerial leadership is incompetent, ineducable, or simply suspicious of economic reform -- e.g., anything that hints at privatization. Finally, a last group of ministers is already looking to their political careers and, as such, do not want to be seen as taking controversial or unpopular actions. END COMMENT.)

15. (C) When the ministers meet as the Council of Ministers, they do, nonetheless, constitute an important body that can pass decrees that bypass the National Assembly (TNA). One recent example is the GOI decision to start rationing gasoline in Baghdad. Ultimately, though, the GOI budget has to be approved by the TNA. Thus, had the Council approved the 2005 supplemental, TNA approval would have been necessary.

Moving the 2006 Budget

16. (C) Currently, the Council of Ministers has approved the proposed structure of the 2006 budget as presented to them by the Ministry of Finance. Allawi told us that this budget structure contains a strategy to take on fuel price and food basket subsidies (reftel), as well as what he believes is a credible approach to increasing oil production through increased spending for infrastructure protection. Currently, the MoF is working to elicit budget requests from the ministries. Once these requests are received, the MoF will work with the Ministry of Planning to present a draft annual budget to the Council for its approval. Once approved, the budget will go to the Council of Ministers and TNA for approval. Allawi told us that he expects the TNA to pass the 2006 budget in mid-November. NOTE: The TNA, operating under budget processing rules developed by the CPA, has the right to reallocate spending and to increase overall expenditures. The TNA has until the end of the calendar year to pass the budget. If the TNA does not do so then the MoF can approve sequential monthly spending units based on 1/12th of the previous year's budget. END NOTE.

The Distractions of the Political Calendar

17. (C) The current political class remains transfixed by the referendum on the Constitution and the December elections. Discussion in the TNA of unrelated matters has come to a near-halt. One example is the proposed legislation to liberalize gas imports for reselling at non-subsidized prices. That would usefully legalize the robust market in black market fuel sales, opening them for revenue collection and halting the subsidy hemorrhage. While some ministries are thinking about market liberalization, attracting foreign investment, and privatization, much of this comprises studies, conferences and meetings -- often in Amman, to the chagrin of some ministers who would prefer that conferences on marketing opportunities take place in Iraq.

18. (C) COMMENT: It is difficult to see any economic area in which the current Council of Ministers, the Prime Minister, or the TNA might want to assert themselves by any concrete steps or decisions for the rest of the year. The one exception is passage of a 2006 budget. It is a tribute to the Minister of Finance that he is willing to pitch against this political calendar and drive, first, the Council of Ministers, and then the TNA to approve it. We note that this political bravery seems to be accompanied by considerable personal bravery as well, as the Minister's convoy has been hit twice in the past several months and many of his Personal Security Detail (PSD) killed. END COMMENT.

19. (C) Allawi feels that recent Article IV consultations with the IMF went reasonably well. He is well-aware that the Paris Club expects Iraq to reach agreement with the IMF for new Standby Arrangements by year-end. He appreciates the importance of reducing fuel subsidies by at least USD 1 billion, passing regulations for implementing the Financial Management Law, auditing the Central Bank of Iraq (CBI), and developing good-quality and timely financial and fiscal reporting. The IMF is also looking at many other issues, including the adoption of plans for state-owned bank restructuring; a commitment to consider some state-owned enterprises (SOE) for privatization; implementation of international auditing and accounting standards; the development of a functioning payments system; and full

implementation of a financial management information system. On these issues Allawi will be prepared to discuss progress achieved so far, while offering constructive ideas for what more needs to be done. He is likely to offer also a frank appraisal of this government's limited ability to do much more than act on the budget in the economic realm.

Comment

10. (C) While a few of the ministers "get" the importance of the 2006 budget for the IMF SBA and the relationship between a SBA and debt forgiveness, this has not yet emerged as a hot topic in Iraq. Allawi has privately told us that his strategy is to attempt to lock-in reforms by tying them to IMF conditionality -- thus setting the stage for a classic "blame the IMF" as the basis for securing political approval for necessary changes. The challenges facing the Minister are manifold. The economic situation is extremely difficult, making many hesitant to take actions that would further fray the social safety net, no matter how dysfunctional it might be in its current state. Those tough decisions have taken an even more formidable appearance as the end of this government's tenure approaches. Finally, the political calendar continues to focus the government's energy and time on the constitutional debate and ratification process. That should culminate on October 15, with intense political campaigning for the December 15 elections following in short order. END COMMENT.
Satterfield